HOUSE BUDGET COMMITTEE

Democratic Caucus

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Rosy Revenue Assumptions
Help Administration Hit Its Fiscal Targets

In its Mid-Session Review of the budget, the Administration claimed that its economic plan will hit two important fiscal targets: (1) the unified deficit will be smaller in 2003 than it is this year and (2) there will be a small unified surplus in 2005. The Administration's prediction relies on an assumption that Federal revenues will increase at an implausibly rapid rate, with especially large jumps in 2003 and 2005. OMB employs three highly questionable assumptions that boost its revenue projections:

- First and most important, the Administration appears to expect a prompt and strong rebound on Wall Street that will boost tax collections on capital gains, stock options, and executive bonuses.

- Second, OMB has reversed its earlier assumptions about the share of non-taxable items (like employee health benefits) in GDP.

- Finally, the Administration presumes historically large jumps in corporate profits will occur just when it needs them to hit its fiscal targets in 2003 and 2005.

Even taking OMB's rosy revenue projections at face value, the ten-year unified budget surplus has plummeted from $5.6 trillion 18 months ago to $0.4 trillion today. Even the rosy estimates result in a $2.0 trillion invasion of the Social Security surplus. Using more credible assumptions, the reported $5.2 trillion budget deterioration could easily be a half trillion dollars worse. Recognizing all the costly priorities that the Administration claims to care about but does not include in its budget numbers — fixing the alternative minimum tax, extending popular expiring tax provisions, the President's professed commitment to increased foreign aid and quality education, strengthening Social Security — would widen the deficit by trillions more.

Having Bet the Budget on the Stock Market and Lost, The Administration Is Poised to Do It Again

OMB Director Daniels emphasizes in the Mid-Session Review that the sagging stock market had a severe impact on revenues this year. Withheld taxes, which come from employee paychecks, seem to have tracked GDP and employment as expected. However, taxes that are not withheld — and which reflect in large part capital gains, stock options, and executive bonuses — have slumped along with the stock market.

Director Daniels claims that the fall-off of taxes related to the stock market was unexpected, declaring, "No one, as far as I know, really saw this coming." However, House Budget Committee Democrats published reports — both before last year's big tax cut (March 12, 2001) and after (December 13, 2001) — specifically warning that the inflated stock market was boosting budget projections of large surpluses, perhaps unsustainably.

The slump in revenues this year should have been no surprise for one reason: Tax collections each April reflect tax liabilities incurred the year before. ***That means that a sagging stock market in one year affects tax receipts from capital gains, stock options, and executive bonuses in the following year.***

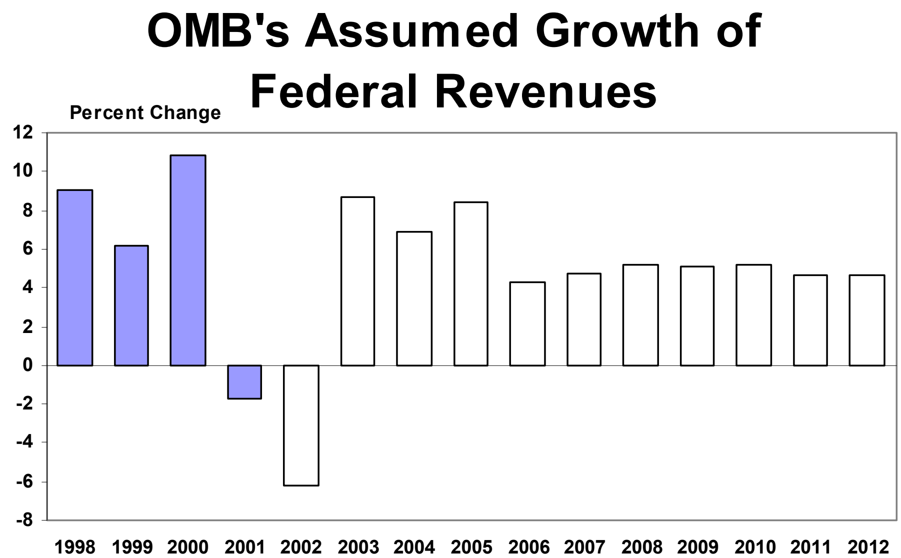
The table below shows this lagged relationship between the stock market and revenues. The large stock market increases in calendar years 1997, 1998 and 1999 pushed up revenues to the Treasury in fiscal years 1998, 1999, and 2000, respectively. When the market flattened in 2000, posting an increase of only 7 percent for the year, that plus the slowing economy caused revenues to fall slightly in 2001. Then, the market in 2001 averaged 16 percent below its 2000 level, and tax receipts this April sank, pushing down estimated revenues for 2002 by 6.23 percent, or $124 billion.

The Stock Market Affects Revenues with a Lag

Fiscal Year	**Change in Revenues**	**Change in S&P 500 Annual Average, *Preceding* Calendar Year**	
1998	**9.02 %**	**30 %**	**(Calendar Year 1997)**
1999	**6.14 %**	**24 %**	**(Calendar Year 1998)**
2000	**10.82 %**	**23 %**	**(Calendar Year 1999)**
2001	**-1.69 %**	**7 %**	**(Calendar Year 2000)**
2002 estimated	**-6.23 %**	**-16 %**	**(Calendar Year 2001)**
2003 projected	**8.68 %**	**?**	
2004 projected	**6.90 %**	**?**	
2005 projected	**8.39 %**	**?**	

The Administration goes to great lengths to note how it now recognizes its mistake. However, having failed to recognize the precariousness of surpluses premised on stock market performance in the past, the Administration's new projections repeat the very same mistake.

As shown in the chart below, OMB foresees revenue growth over the next three years rivaling the best years of the late 1990s. Over the next three years, OMB assumes revenue growth will average 8.0 percent, only a bit below the 8.6 percent average for 1998, 1999, and 2000. These growth rates exceed the 7.0 percent pace averaged for the 1990s as a whole, for the 1980s, and for the last half century.



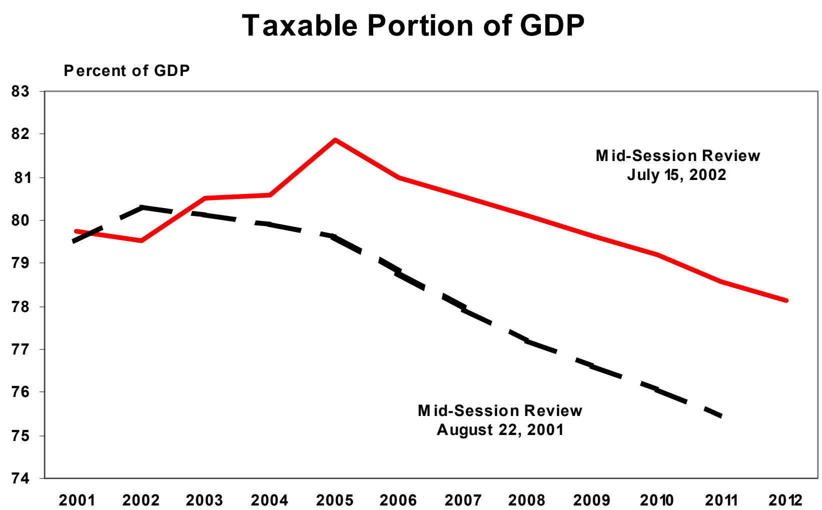
This forecast of an abrupt recovery to above-average revenue growth is hard to accept given the stock market's low level at present. In order for this year's market average to exceed last year's, it would require an extraordinary stock market recovery in the next five months.

Even if the S&P 500 rose in a straight-line fashion to a level more than double its current value by the end of the year, its 2002 average would merely match the 2001 average. If instead the S&P 500 stayed at its current depressed level for the remainder of the year, the 2002 average would be 20 percent below last year. In this event, the revenue shortfall next year due to depressed income from capital gains, stock options, and executive bonuses might be as large as the one this year.

Of course, withheld taxes from employees' paychecks will presumably grow if earnings and employment recover as the Administration projects, offsetting some revenue weakness due to the sagging stock market. OMB now assumes that GDP in every year of the next decade will be higher than it assumed just five months ago. But even if this forecast is born out, withheld tax receipts probably would not outweigh a significant revenue decline associated with a weaker stock market, just as it failed to do so this year. After all, personal income rose a surprisingly strong 4.9 percent in 2001 despite the recession, but overall revenues still fell 6.23 percent, or $124 billion, when 2001 taxes were filed this year.

The Administration's Dubious Assumptions About Non-Taxable Income and Surging Corporate Profits in 2003 and 2005

OMB also makes a rather questionable assumption about the total share of income subject to tax between now and 2005. A year ago, OMB assumed that the portion of GDP subject to tax would fall steadily over the next decade. In large part, this was due to the expectation that rising health care costs probably will push up the share of compensation that employees receive as health benefits, which are not taxed. Now, just five months later, the Administration predicts that the taxable share of GDP will jump between now and 2005 and remain above its earlier prediction thereafter. This assumption seems strange in light of the recent acceleration of health care cost increases.



One of the reasons why the Administration foresees a higher taxable share of GDP is that OMB assumes dramatic jumps in taxable corporate profits in 2003 and 2005. According to the Mid-Session Review, corporate profits will soar by more than 20 percent in 2003 and by more than 25 percent in 2005, bracketing a respectable 7.8 percent advance in 2004. This seems speculative, given that profits have jumped by 25 percent or more only three times and by 20 percent or more only six times in the last half century. Here again, the Mid-Session Review assumes consistently stronger corporate profits throughout the next decade than the Administration's February budget forecast.